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Marketing Material

THE DEBTS THAT RECESSIONS LEAVE BEHIND: WHAT'S A CREDITOR TO THINK?

David Bianco
Chief Investment Officer, Americas

IN A NUTSHELL

_ Recessions bring debts that pose opportunities and risks for creditors
_ U.S. federal government: U.S. credit risk is inflation risk, a risk to monitor
_ U.S. state and local governments: federal support and austerity is likely
_ Efficient infrastructure stimulus requires local government partnership
_ First quarter earnings season: wish they all could be virtual technology firms

RECESSIONS BRING DEBTS THAT POSE OPPORTUNITIES AND RISKS FOR CREDITORS

Modern recessions are met with fiscal policy that mitigates the contraction, but raises government debt. This spreads the hit of an economic shock over time by delaying taxes and pulling forward spending. This is wise countercyclical fiscal policy because recessions can bring destructive multipliers without countervailing forces and confidence support. These Keynesian principles[1] are revisited every recession and are widely understood and advocated. Ideally, extraordinary deficits incurred from recessions would be repaid during expansions. This suggests that shock damage should be gauged by considering both the peak-to-trough contraction in gross domestic product (GDP) and the pre-to-post recession climb in federal debt to GDP, noting that stimulus efficiency will vary independent of the shock. Because the debt that recessions leave behind is important, so too is stimulus efficiency. The ability to repay higher debt over the new cycle should be evaluated or the ability to sustain it in a debt capacity context. These concepts should help guide creditors, whether holding Treasuries, municipals, corporate bonds or other debts through this downturn.

U.S. FEDERAL GOVERNMENT: U.S. CREDIT RISK IS INFLATION RISK, A RISK TO MONITOR

The federal government is like a giant insurance company with an army. It insures social stability through law, common defense, economic welfare and other safety nets that transfer from spots and times of prosperity to without. Much of the taxes it collects are like premiums for this insurance. The federal government mostly taxes labor and production through income and payroll taxes and also corporate profit and investment return taxes. If debt service becomes a difficult burden the simple choices are to reduce services or raise taxes. Before this recession, federal debt to GDP was 23 trillion dollars or 110% of 2019 GDP. We expect it to rise to about 135% in 2021 from deficits of about 4 trillion dollars in 2020 and 2 trillion dollars in 2021. These high debt levels might eventually bring higher real interest rates or cause the U.S. Federal Reserve (Fed) to tolerate higher inflation.

Efficient fiscal stimulus mitigates the risk of tight future budgets. Looking back at last recessions, capital injections to the banks by the Treasury were the most efficient stimulus, albeit least popular. It restored bank stability and the government earned interest and warrants on its capital. New Federal Reserve run credit facilities for companies and municipalities appear most similar. However, other stimulus programs had less efficiency. Stimulus checks before and during the recession were in significant part saved. Infrastructure funding within the 2009 Recovery & Reinvestment Act was dispersed across the country, including non-economic investment usage on new playground equipment, field lights, fencing, etc. This should be carefully targeted if tried again. Infrastructure stimulus is never quickly done, so a good blueprint is well worth the wait. Unemployment insurance is history's most effective countercyclical policy. Expanding it in crisis makes sense, but perhaps not by an extra 600 dollars per recipient over the normal weekly bene-

[1] Keynesian economics are various macroeconomic theories about how in the short run – and especially during recessions – economic output is strongly influenced by aggregate demand.

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fit nationwide for 19 weeks if the lockdowns are not as long or nationwide. The Paycheck Protection Program is innovative in keeping employees affiliated with their workplace, but the first-come first-serve loan grant process quickly depleted the initial allocation. We strongly advocate fiscal stimulus, but efficiency is needed to ensure long-term fiscal health. A Treasury bond default on inability to pay is inconceivable given the ability to print currency. Thus, U.S. credit risk is really inflation risk. The federal government took exclusive right to coin money when it assumed the debt of the states after the revolution. Thus, ability to pay is a state and local credit-risk issue.

U.S. STATE AND LOCAL GOVERNMENTS: FEDERAL SUPPORT AND AUSTERITY IS LIKELY

State and local governments are like giant real-estate firms with their own schools and police. Much of the taxes collected can be thought of as rent for using the land and associated services. Sometimes these "landlords" enhance the use and appeal of their land by making improvements through state sponsored authorities that run operations like mass transit, airports, universities, or essential services like water, sewer, and sanitation. State and local governments mostly tax land ownership with property taxes and personal property through sales tax. State and local spending is 11% of GDP; some of this is in personal consumption like most federal spending at 22% of GDP. The ten highest spend states are 55% of the total. Government expenditures are generally counted in GDP without quantity or quality productivity adjustments. However, clearly what taxpayers are getting for tax paid, such as for schools, differs this spring vs. last.

Municipal bonds are the obligations of state or local governments or the special purpose authorities they sponsor, whose debts they might or might not guarantee. Most of the country's public infrastructure is built and operated by state and local authorities. About 75% of annual public infrastructure spending is done by local government or nearly all setting aside the national highway system. States are supposed to run balanced budgets, but many do not and have the legal means to run deficits and issue moderate transitory debt under general obligation bonds. States cannot print money or declare bankruptcy (dissolve), but they can default on their debt, which would force creditors to turn to the courts and perhaps be subject to a restructuring plan.

EFFICIENT INFRASTRUCTURE STIMULUS REQUIRES LOCAL GOVERNMENT PARTNERSHIP

We would like to see strategic infrastructure investments planned for the recovery in partnership with the state-sponsored authorities with well-established competence in public infrastructure projects. We think big city mass transit and commuter rail systems will need complete renovations to help foster a strong recovery of the services industries located in big cities.

FIRST QUARTER EARNINGS SEASON: WISH THEY ALL COULD BE VIRTUAL TECHNOLOGY FIRMS

First quarter 2020 S&P 500 earnings per share (EPS), 70% reported. Results point to final first quarter S&P 500 EPS to be down 20% year-over-year. Results bifurcated growth / defensive vs. value / cyclical. It will likely amplify in the second quarter. Virtual and essential businesses are most resilient, but cyclical value is very vulnerable with long recoveries ahead.

GLOSSARY

A corporate bond is a bond issued by a corporation in order finance their business.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Municipal bonds (Munis) are debt securities issued by a state, municipality or country.

The real interest rate is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The U.S. dollar (USD) is the official currency of the United States and its overseas territories.

The U.S. Federal Reserve, often referred to as "the Fed", is the central bank of the United States.

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

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